

Special Retroactive Tax Exemption Enacted For Wrongful Conviction Settlements



Robert W. Wood is a tax lawyer with www.WoodLLP.com, and the author of numerous tax books including *Taxation of Damage Awards & Settlement Payments* (www.TaxInstitute.com). This discussion is not intended as legal advice.

Robert W. Wood

The Wrongful Convictions Tax Relief Act is a long overdue change to the tax code.¹ The new law amends the Internal Revenue Code (“IRC”) to allow a wrongfully convicted individual to exclude civil damages, awards, and other compensation paid for wrongful incarceration.²

Few of us can imagine what it would be like to be convicted and imprisoned for crimes we did not commit. In 2015, wrongfully convicted individuals exonerated by DNA evidence served an average of 14.5 years behind bars.³ Since the first DNA exoneration in 1989, wrongfully convicted people served more than 3,809 years in prison before being exonerated.⁴ Whether viewed individually or in the aggregate, the number of wrongful convictions is astounding.

Prior to the passage of the new law, if a wrongfully convicted individual or exoneree received compensation from the state for wrongful imprisonment, the payment was taxable. To avoid taxation, the exoneree would have to prove that the state paid the funds to redress physical injury suffered behind bars.⁵

Historical Background

Few people argue that recoveries for wrongful convictions should be taxed, but prior to passage of the new law, the IRC did not provide an express exemption. Our justice system is complex, and sometimes gross injustices occur. When they do and are eventually rectified, the person is never the same.

For the few who end up with money to help pay for their ordeal, adding the Internal Revenue Service (“IRS”) collectors into the mix can be salt in the wounds.

And not every exoneree is well advised or equipped to handle a query from the IRS about a legal settlement. Yet until now, the tax issues have been surprisingly cloudy.

In the 1950s and 60s, the IRS issued a series of rulings involving prisoners of war, civilian internees, and holocaust survivors.⁶ Sensibly, the IRS ruled that their compensation was tax-free irrespective of whether they suffered physical injuries. The IRS’s rulings did not rely on IRC § 104.

IRC § 104(a)(2), as amended in 1996, excludes from gross income damages received on account of personal physical injuries or physical sickness. In evaluating whether awards paid to exonerees should be taxable, courts, unlike the IRS, focused on § 104.

In *Stadnyk v. Commissioner*,⁷ the Tax Court and Sixth Circuit ruled that physical restraint and physical detention are not “physical injuries” for purposes of § 104(a)(2). Ms. Stadnyk was held at a local sheriff’s office for approximately eight hours. The sheriff’s handcuffed and photographed Ms. Stadnyk, performed a pat-down search, and confined Ms. Stadnyk to a holding area. She suffered no observable bodily harm, and she admitted that she was never injured or even roughed up. The Tax Court concluded that the deprivation of personal freedom is not a physical injury for purposes of § 104(a)(2). The Sixth Circuit affirmed, noting that while false imprisonment involves a physical act—restraining the victim’s freedom—it does not mean that the victim is *necessarily* physically injured as a result.⁸

Stadnyk involved short-term incarceration.⁹ The holding, however, affirmed the importance of § 104(a)

(2)'s requirement that "there must *also* be physical injury."¹⁰

Problems with § 104 on Exoneree Cases: Lack of Physical Injury

Under § 104, if an inmate was seriously injured in prison, § 104 might exclude the entire recovery. Yet even then, normal IRS rules would suggest allocating the recovery between amounts that are tax-free and those that are not.¹¹ The problem is that in many exoneree cases, the exoneree is never physically injured despite the wrongful physical confinement.

If the § 104 model was not helpful in excluding an entire recovery, perhaps one could rely on the non-statutory general welfare exception? After all, the government is typically paying the money. Moreover, the government is paying someone for depriving them of their freedom and welfare.¹² Unfortunately, little attention is usually given to the general welfare exception. That brings us back to the uneasy topic of § 104.

Exonerees May Receive an Award from the State to Redress Multiple Harms, Many of Which Are Taxable

First Pain Incident Approach

As the voluminous § 104 authorities make clear, the statute's post-1996 iteration requires that the payment be made on account of physical injuries, sickness, or related emotional distress.¹³ If a payment is for emotional distress *not* arising out the physical injuries or physical sickness, then tax applies.¹⁴ This invites discussion over just *why* the payment is being made, or more exactly, in the language of the statute, "on account of" what the payment is being made.

The payment may be for a mix of damages, including loss of freedom, loss of career, loss of consortium, loss of familial association, loss of reputation, emotional distress, and more. The exoneree may have been beaten, roughed up, subjected to inadequate medical treatment, and more. These latter items often become the primary reason an exoneree receives tax-free treatment.

Positions vary on whether one should allocate monies between these pure physical elements and the more generic wrongful imprisonment damages. Tax lawyers are inclined to allocate. In the IRS "bruise" ruling, the IRS asserted that all of the damages in a sex

harassment case leading up to the "First Pain Incident" are taxable.¹⁵

All of the damages (including emotional distress damages) accruing after the First Pain Incident are tax-free. Does the sex harassment case discussed in the bruise ruling have a wrongful imprisonment analog? If so, it would perhaps be a case in which a person is wrongfully arrested, convicted, and imprisoned for say ten years before being exonerated and released. Suppose it is five years into the sentence before he is assaulted and beaten or hurt in a botched operation in the prison hospital, or experiences some other "First Pain Incident." Does that mean all of his recovery attributable to the time *before* the First Pain Incident is taxable? The author believes that the loss of liberty and physical confinement is *itself* a physical injury within the meaning of § 104.

However, the author's view is not supported by the authorities. Recall that in *Stadnyk v. Commissioner*,¹⁶ the Sixth Circuit held that while false imprisonment involves a physical act—restraining the victim's freedom—it does not mean that the victim is *necessarily* physically injured as a result.¹⁷

The issue came up in a hearing on § 104 regulations in February 2010. Then, the IRS published Chief Counsel Advice 201045023.¹⁸ This IRS ruling states that a victim of wrongful imprisonment who "suffered physical injuries and physical sickness while incarcerated" can exclude his recovery from taxes. If the exoneree had physical injuries, the damages are tax-free, just like more garden variety personal physical injury recoveries. If not . . . well, we don't like to talk about that one.

There are usually significant levels of physical injuries and sickness in long-term wrongful imprisonment cases. For that reason, as a practical matter, experienced tax practitioners often characterize the provisions of a settlement in a manner that appeals to the IRS. But is that really why the victim is getting most of the money? Usually, no.

It may be difficult, or even impossible, to separate out all of the multiple levels of horror, all the losses that can never be made up. But in many cases, the loss of physical freedom and civil rights is at the root of the need for reparations. Although the author commends the IRS for its position in IRS Chief Counsel Advice 201045023, the ruling did not solve all the issues.

Chief Counsel Advice 201045023 does not attempt to allocate an amount paid under the state statute between the payment for physical injuries and sickness and the other damages. The author applauds that treatment, for the “First Pain Incident” analog does not make sense in the exoneree context. Perhaps the IRS did not think so, either.

The state statute in the Chief Counsel Advice awarded money based on tenure in prison using a kind of *per diem* approach. The fact that the IRS does not broach the allocation point might mean that the IRS views the money as all for the physical injuries and sickness. It might mean that the time-based payment is carried along with the physical injury payment. It might even mean that the time-based payment on its own would be tax-free, though the latter seems the least likely meaning. In any case, the IRS does not attempt to parse the recovery in Chief Counsel Advice 201045023. Still, what of an exoneree who spends years in prison but, like Mrs. Stadnyk, says he was never roughed up, never beaten, never given inadequate medical care?

New Day

With the new legislation, these recoveries are now tax-free, even retroactively. Congressmen Johnson (R-TX) and Larson (D-CT) introduced their bill multiple times. In 2015, they re-introduced the Wrongful Convictions Tax Relief Act. Several members of the Senate, including Charles Schumer (D-NY) and John Cornyn (R-TX), joined in.

The new law says that exonerees no longer have to prove that they were physically injured in prison to get tax-free treatment. Exonerees also no longer have to fudge the allocation of the money. You no longer need to suggest that you received millions for getting stabbed or beaten up while in prison and nothing for spending fifteen years wrongfully behind bars.

The Wrongful Convictions Tax Relief Act allows exonerees to keep their awards tax-free. According to Congressman Larson, “[t]hrough we can never give the wrongfully convicted the time back that they’ve had taken from them, they certainly shouldn’t have to pay Uncle Sam a share of any compensation they’re awarded. This bill will make sure they don’t have to suffer that insult on top of their injury.”¹⁹

§ 139F of the IRC now provides that:

In the case of any wrongfully incarcerated individual, gross income shall not include any civil damages, restitution, or other monetary award (including compensatory or statutory damages and restitution imposed in a criminal matter) relating to the incarceration of such individual for the covered offense for which such individual was convicted.

As one might expect in any tax code section, there are definitions. A “wrongfully incarcerated individual” means an individual who was convicted of a covered offense, who served all or part of a sentence of imprisonment relating to that covered offense, and:

(A) who was pardoned, granted clemency, or granted amnesty for that covered offense because that individual was innocent of that covered offense, or

(B)(i) for whom the judgment of conviction for that covered offense was reversed or vacated, and (ii) for whom the indictment, information, or other accusatory instrument for that covered offense was dismissed or who was found not guilty at a new trial after the judgment of conviction for that covered offense was reversed or vacated.

Finally, a “covered offense” means any criminal offense under federal or state law and includes any criminal offense arising from the same course of conduct as that criminal offense.

The law has an unusual effective date. At first, it even seems hard to understand: “The amendments made by this section shall apply to taxable years beginning before, on, or after the date of the enactment of this Act.” Then, the provision goes on to include a waiver of the statute of limitations:

If the credit or refund of any overpayment of tax resulting from the application of this Act to a period before the date of enactment of this Act is prevented as of such date by the operation of any law or rule of law (including *res judicata*), such credit or refund may nevertheless be allowed or made if the claim therefor is filed before the close of the 1-year

period beginning on the date of the enactment of this Act.

Punitive Damages

Does the new law cover punitive damages as well as compensatory ones? That is an interesting question. One might note that the provisions of new code § 139F do not say that punitive damages are taxed. That is a contrast from § 104, which makes that point explicit. Perhaps that means that § 139F excludes any punitive damages too. It appears that some people are reading the law in this way.²⁰ On the other hand, there is also nothing in § 139F to expressly state that punitive damages are tax-free.

One can argue—as the IRS has in the past—that punitive damages are by definition not to compensate the plaintiff for anything. Punitive damages are to punish. That would suggest, as the Supreme Court held in *O’Gilvie*,²¹ that punitive damages are not compensating for an injury and therefore cannot be tax-free. This may be an academic point unless and until an exoneree receives punitive damages. But that does not seem outside the realm of possibility. And it seems easy to imagine the taxpayer and the IRS disagreeing over this.

Structured Settlements

With many physical injury cases, the plaintiff may want to ‘structure’ all or a part of his recovery. § 104 clearly contemplates this. § 104 says that the damages are tax-free in a lump sum or in periodic payments.

With periodic payments, 100 percent of each payment will be tax-free. This is so even though a portion of those periodic payments could be viewed as investment return on the lawsuit proceeds. The plaintiff only wants to be sure that he will receive all of the promised payments over time, and that each payment is tax-free. But the mechanics are complex. Defendants want to pay a lump sum, and no plaintiff would want to rely upon the defendant to pay like clockwork over time. Accordingly, insurance companies that write structured settlement annuities fill the void. The defendant or insurer transfers the obligation to an assignment company, which will make the payments to the plaintiff. If the assignment qualifies under § 130, the assignment company is sure that the payment it receives is not income for federal income tax purposes. Even

with the new law, however, it is unclear how wrongful conviction recoveries will be structured from now on.

Up until now, the settlement agreement and structure documents in a wrongful conviction settlement would refer to §§ 104 and 130. Now, unless one continues to use personal physical injury language and to rely on §§ 104 and 130, there will be a mismatch. That is, § 139F does not work in tandem with § 130. This may be a mere technical glitch that can be overcome in one of several ways. But it may be causing some worries. One suggestion I recently heard was to use non-qualified structured annuities, of the same type one would employ for taxable periodic payments.

On first blush, this strikes me as a terrible idea. First, it will dramatically limit the number of companies that can write the annuities. There are approximately fifteen big life insurance companies that write qualified (§ 130) annuities. There are approximately two that write non-qualified ones. Even worse, it sets up the protocol for taxable payments with a Form 1099 every year to the plaintiff. Perhaps there are ways to counteract that. And if the IRS later tries to tax the payments, presumably § 139F would be sufficiently clear that the IRS should go away. However, this could lead to administrative tax problems galore. It seems like an unfortunate train to set off down the tracks, particularly with insurance products and companies that are not used to altering their Form 1099 protocols. They issue Form 1099s in non-qualified cases, and that is likely to be that.

Conclusion

The tax code does not always make sense. And it is not always clear.

With wrongful conviction recoveries, though, it is now clear that lump sums or periodic payments are tax-free. There may be a few definitional issues in the future, and it seems conceivable that punitive damages may become a bone of contention. Furthermore, there may be some changes in the structured settlement field. But this is a very good change in the law.

Endnotes

- 1 Pub. L. No. 114-113, § 304 (2015).
- 2 An exoneration is a legal requirement for the tax exclusion to apply. Thus, the new law covers only exonerees. It does not apply to a false imprisonment recovery—or any other claim—by a person who may have been mistreated but is not later found to actually be innocent.

- 3 See *The National Registry of Exonerations: Exonerations in 2015* (Feb. 3, 2016), http://www.law.umich.edu/special/exoneration/Documents/Exonerations_in_2015.pdf.
- 4 See Press Release, Congressmen Sam Johnson and John Larson Introduce Legislation to Assist Those Wrongfully Convicted (Mar. 22, 2012), available at <http://samjohnson.house.gov/news/documentsingle.aspx?DocumentID=286340> (last visited September 19, 2016).
- 5 See I.R.C. § 104. Thirty-one states, the District of Columbia, and the federal government provide some form of statutory compensation for wrongful conviction and incarceration. The following nineteen states do not: Alaska, Arizona, Arkansas, Delaware, Georgia, Idaho, Indiana, Kansas, Kentucky, Michigan, Nevada, New Mexico, North Dakota, Oregon, Pennsylvania, Rhode Island, South Carolina, South Dakota, and Wyoming. Some plaintiffs sue in state court under a state wrongful incarceration statute, in federal court for violation of civil rights, or in state court for the torts of false imprisonment or malicious prosecution. The states vary in the maximum amount of their payout, and in the means used to measure the awards. For a comprehensive list, see the “How is your state doing” database provided by the Innocence Project, available at <http://www.innocenceproject.org/policy/>.
- Some states also include lost wages in addition to the compensation otherwise provided by the statute. See, e.g., IOWA CODE § 663A.1; OHIO REV. CODE ANN. § 2743.48.
- Apart from state statutes, there are federal statutes. 28 U.S.C.S. §§ 1495, 2513. They were originally enacted in 1948 and substantially revised by the Innocence Protection Act of 2004, part of the Justice for All Act of 2004 (JFAA). Pub. L. 108-405, 118 Stat. 2293. In addition to state and federal statutes of general application, some state legislatures have weighed in with targeted legislation to compensate a particular wronged person. See, e.g., CAL. REV. & TAX CODE § 17156 (providing for exclusion from income for the \$620,000 paid by the State of California to Kevin Lee Green as compensation for seventeen years of wrongful imprisonment).
- 6 Rev. Rul. 55-132, 1955-1 C.B. 213; Rev. Rul. 56-462, 1956-2 C.B. 20; Rev. Rul. 56-518, 1956-2 C.B. 25; Rev. Rul. 58-370, 1958-2 C.B. 14.
- 7 T.C. Memo 2008-289, *aff’d* without published opinion (6th Cir. 2010).
- 8 *Id.* (italics in original). For more on *Stadnyk*, see Robert W. Wood, *Why the Stadnyk Case on False Imprisonment Is a Lemon*, 127 TAX NOTES 1, Apr. 5, 2010, at 115.
- 9 *Stadnyk*, T.C.M. 2008-289.
- 10 *But see Public Hearing on Proposed Regulations*, 26 C.F.R. pt. 301, *Damages Received on Account of Personal Physical Injuries or Physical Sickness* [Treas. Reg. 127270-06], Doc. 2010-4501, 2010 TNT 41-15, at 10 (Feb. 23, 2010) (comments of Mike Montemurro, Branch Chief, I.R.S. Office of Assoc. Chief Counsel for Income Tax and Accounting) (“I mean I don’t know that the Service has ever gone to court on litigation, you know, I know the Service doesn’t ever go to court on litigation, [regarding] anybody who’s been falsely imprisoned or anyone who’s suffered any sex abuse, as far as asserted in a courtroom that those kinds of damages are taxable, I mean whatever the pure technical answers may be.”).
- 11 See Robert W. Wood, *Tax-Free Wrongful Imprisonment Recoveries*, 130 TAX NOTES 8, Feb. 21, 2011, at 961.
- 12 Robert W. Wood, *Are False Imprisonment Recoveries Taxable?*, 119 TAX NOTES 3, Apr. 21, 2008, at 287. For more general information on the general welfare exception, see Robert W. Wood, *The Evergreen General Welfare Exception*, 126 TAX NOTES 10, Mar. 8, 2010, at 1271; Robert W. Wood, *Updating General Welfare Exception Authorities*, 123 TAX NOTES 12, June 22, 2009, at 1443.
- 13 See H.R. REP. NO. 104-737, at 301 (1996) (Conf. Rep.).
- 14 See *id.*
- 15 I.R.S. Priv. Ltr. Rul. 200041022 (July 17, 2000).
- 16 *Stadnyk v. Comm’r*, T.C. Memo 2008-289, *aff’d* without published opinion (6th Cir. 2010).
- 17 *Id.* (italics in original). For more on *Stadnyk*, see Robert W. Wood, *Why the Stadnyk Case on False Imprisonment Is a Lemon*, 127 TAX NOTES 1, Apr. 5, 2010, at 115.
- 18 (Nov. 4, 2010).
- 19 See Press Release, Congressmen Sam Johnson and John Larson introduce legislation to assist those wrongfully convicted (Mar. 22, 2012), <http://samjohnson.house.gov/news/documentsingle.aspx?DocumentID=286340>.
- 20 RIA’S COMPLETE ANALYSIS OF THE PROTECTING AMERICANS FROM TAX HIKES ACT OF 2015, OTHER TAX PROVISIONS OF THE CONSOLIDATED APPROPRIATIONS ACT, 2016, AND EARLIER 2015 TAX AND PENSION ACTS ch. 100, ¶ 120.
- 21 519 U.S. 79 (1996).